

UNITED STATES TAX COURT
WASHINGTON, DC 20217

TIMOTHY J. ELMES,)	
)	
Petitioner,)	
)	
v.)	Docket No. 22003-11.
)	
COMMISSIONER OF INTERNAL REVENUE,)	
)	
Respondent)	
)	
)	

ORDER

Petitioner filed a motion to dismiss for lack of jurisdiction pursuant to Rule 53¹ on November 12, 2014. The issue to be decided concerns the validity of the notice of deficiency issued to petitioner, specifically whether respondent “determined” a deficiency in petitioner’s 2002, 2003, and 2004 Federal income tax within the meaning of section 6212(a).

Unless otherwise indicated, all section references are to the Internal Revenue Code in effect for the years at issue, and all Rule references are to the Tax Court Rules of Practice and Procedure.

Background

Petitioner resided in Florida when he filed his petition. He is a U.S. citizen. Claiming to be a bona fide resident of the U.S. Virgin Islands (Virgin Islands) in 2002, 2003, and 2004, petitioner (1) filed income tax returns with the Virgin Islands Bureau of Internal Revenue (VIBIR) and (2) claimed he qualified for the section (c)(4) gross income exclusion and therefore did not have to file a Federal income tax return or pay Federal income tax for those years. The Internal Revenue Service (IRS) audited petitioner’s 2002, 2003, and 2004 Virgin Islands income tax

¹Petitioner’s motion is premised on the principles set forth in Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987), rev’g 81 T.C. 855 (1983).

returns, and on June 28, 2011, issued petitioner a notice of deficiency determining the following Federal income tax deficiencies and additions to tax:

<u>Year</u>	<u>Deficiency</u>	<u>Additions to tax</u>		
		<u>Sec. 6651(a)(1)</u>	<u>Sec. 6651(a)(2)</u>	<u>Sec. 6654</u>
2002	\$444,908	\$96,270.30	\$106,967.00	\$14,234.85
2003	937,518	208,674.90	231,861.00	23,904.12
2004	556,063	125,114.17	139,015.75	15,935.13

Attached to the notice of deficiency was an Explanations of Items, which set forth the basis for the income tax deficiencies and additions to tax:

It has been determined that during taxable years ended December 31, 2002, December 31, 2003, and December 31, 2004, you were not a bona fide resident of the United States Virgin Islands (“USVI”). It is also determined that you participated in a tax avoidance scheme similar to that described in Notice 2004-45 Meritless Position Based on Sections 932(c)(4) and 934(b), which involved improperly claiming to be a resident of the USVI and superficially recasting income from sources within the United States as income from sources within the USVI in order to inappropriately and invalidly claim a tax credit of 90% under the United States Virgin Islands Economic Development Program (“EDP credit”).

It is further determined that all income addressed in this notice of deficiency is US-sourced income and/or not USVI-sourced or effectively connected to a trade or business within the USVI.

Based upon these determinations, you were required to file U.S. Form 1040 income tax returns for tax years 2002, 2003, and 2004 and you failed to do so.

It has been determined that the arrangements between Tim Elmes PA, Atlantic Capital LLC and JE Holdings lack economic substance, and any transaction entered into during tax years 2002, 2003, and 2004 pursuant to any arrangement between these said entities are disregarded for federal tax purposes. Such transactions are devoid of economic purpose and economic substance and were engaged in for no purpose other than to avoid or evade tax. Accordingly, any

amounts paid and deducted pursuant to such transactions are disallowed.

It has also been determined that a number of expenses claimed on the return of Tim Elmes PA for tax years 2002, 2003, and 2004 are not deductible. Accordingly, your distributive share of income from this entity is being adjusted in accordance with adjustments to the items of income, expense, gain, and loss shown on the enclosed report of adjustments, Form 4549, for tax years 2002, 2003, and 2004.²

The notice of deficiency detailed the calculations respondent made in the determination of petitioner's tax.

On September 23, 2011, petitioner filed his petition in this Court. As noted supra, p. 1, on November 12, 2014, petitioner filed his motion to dismiss for lack of jurisdiction.

Discussion

I. Introduction

This Court is a court of limited jurisdiction, and we may exercise our jurisdiction only to the extent authorized by Congress. Sec. 7442; Naftel v. Commissioner, 85 T.C. 527, 529 (1985). We have jurisdiction to redetermine a taxpayer's Federal tax liabilities in a deficiency proceeding only where the Commissioner has issued a valid notice of deficiency and the taxpayer has timely filed a petition. Secs. 6212 and 6213; Rule 13(a), (c); Gustafson v. Commissioner, 97 T.C. 85, 89 (1991). If no valid notice of deficiency was issued, we are compelled to dismiss the case. Monge v. Commissioner, 93 T.C. 22, 27 (1989); Cross v. Commissioner, T.C. Memo. 2012-344.

It is well settled that no particular form is required for the notice of deficiency to be valid. See Benzvi v. Commissioner, 787 F.2d 1541, 1542 (11th

²In 2004, the IRS issued Notice 2004-45, 2004-2 C.B. 33, in which it stated that it intended to challenge "highly questionable, and in most cases meritless, positions" of certain U.S. citizens who claimed to be residents of the Virgin Islands in order to avoid U.S. taxation by claiming substantial tax benefits arising from the tax policies enacted by the Government of the Virgin Islands, including the 90% income tax reduction referenced supra. See Huff v. Commissioner, 135 T.C. 222, 228 (2010).

Cir. 1986); Jarvis v. Commissioner, 78 T.C. 646, 655 (1982). The Court of Appeals for the Eleventh Circuit, the court to which this case is appealable barring a stipulation to the contrary, has held that the notice will be treated as valid if the Commissioner demonstrates that “the IRS has determined that a deficiency exists for a particular year and specify the amount of the deficiency.” Stoecklin v. Commissioner, 865 F.2d 1221, 1224 (11th Cir. 1989) (quoting Benzvi v. Commissioner, 787 F.2d at 1542), aff’g. T.C. Memo. 1987-453.

Petitioner, through counsel, makes two main arguments in support of his motion to dismiss for lack of jurisdiction. First, he cites to Scar v. Commissioner, 814 F.2d 1363 (9th Cir. 1987), rev’g 81 T.C. 855 (1983), and its progeny with regard to their assertion that the subject notice of deficiency is invalid. Second, he asserts that a notice of deficiency is a civil complaint against the taxpayer/petitioner, and in the instant cases the notice/complaint failed to meet the pleading requirements of the Federal Rules of Civil Procedure. For the reasons set forth below, we disagree with petitioner’s assertions.

II. The Virgin Islands

In order for us to decide petitioner’s motion to dismiss, we deem it necessary to review the unique relationship between the United States and the Virgin Islands.

The Virgin Islands is an insular area of the United States; it is classified as an unincorporated territory by 48 U.S.C. sec. 1541(a) and is not part of one of the 50 states or the District of Columbia. It is generally not considered a part of the United States for tax purposes. See sec. 7701(a)(9).

Congress established the “mirror tax system” as the tax law of the Virgin Islands in 1921. Act of July 12, 1921, ch. 44, sec. 1, 42 Stat.123 (codified as amended at 48 U.S.C. sec. 1397 (2006)); see Danbury, Inc., v. Olive, 820 F.2d 618, 620 (3d Cir. 1987). Under this mirror tax system, the Virgin Islands uses the Code with “Virgin Islands” effectively substituted for “United States”, and vice versa. See Id.

The VIBIR does not have its own territorial tax forms; rather, it uses IRS tax forms for reporting purposes. Thus, Virgin Islands individuals file Form 1040, U.S. Individual Income Tax Return, with the VIBIR; Virgin Islands partnerships file Form 1065, U.S. Return of Partnership Income, with the VIBIR; and Virgin Islands corporations file Form 1120, U.S. Corporation Income Tax Return, with the VIBIR.

Section 932(c) coordinates U.S. and Virgin Islands income tax liability and filing requirements for individuals who are subject to U.S. taxation (e.g., U.S. citizens and residents).³ Section 932(c)(2) provides that individuals to whom section 932(c) applies “shall file an income tax return for the taxable year with the Virgin Islands.” Section 932(c)(4) treats an individual who (A) is a bona fide resident of the Virgin Islands; (B) reports income from all sources and identifies the source of each item shown on his Virgin Islands income tax return; and (C) fully pays his tax liability to the Virgin Islands, as having no gross income for U.S. tax purposes. Thus, an individual who is a bona fide resident of the Virgin Islands may satisfy his U.S. tax reporting and payment obligations by filing with, and paying tax only to, the Virgin Islands if he satisfies the remaining requirements of section 932(c). *See* S. Rept. No. 100-445, at 315 (1988), 1988 U.S.C.C.A.N. 4515, 4826. Moreover, any tax collected by the United States must be covered into (i.e., paid to) the Virgin Islands. 48 U.S.C. sec. 1642 (1980).

In order to ensure the “fair implementation” of section 932, the United States and the Virgin Islands entered into an agreement “for the exchange of information and mutual assistance with respect to taxes in order to prevent the evasion or avoidance of United States or Virgin Islands taxes”. Tax Implementation Agreement Between the United States of America and the Virgin Islands (TIA), Feb. 24, 1987, 1989-1 C.B. 347, 347-348. The TIA applies to (1) all taxes imposed by the Code, (2) all taxes imposed by the mirror code, and (3) all local income taxes imposed by the Virgin Islands as authorized by the Tax Reform Act of 1986. *See id.* art. 2, 1989-1 C.B. at 348.

TIA article 4 governs the exchange of information between the two governments. Clause 1 thereof provides that the competent authorities of the United States and the Virgin Islands shall exchange information to administer and enforce their respective tax laws. *See id.* art. 4(1), 1989-1 C.B. at 348. TIA article 4(2)(b) provides that the Virgin Islands shall routinely supply to the United States

³In general, the United States taxes U.S. citizens and alien individuals residing in the United States on all of their income regardless of the income’s origin (i.e., on their worldwide income). *See Cook v. Tait*, 265 U.S. 47, 56 (1924). Gross income for the purpose of calculating taxable income is defined as “all income from whatever source derived.” Sec. 61(a). Individuals subject to U.S. tax are generally required to file a tax return if their income exceeds a threshold amount. Sec. 6012(a)(1)(A). Sec. 932 preempts these general rules if the requirements of the section are met.

information with respect to audit changes that disclose information of interest to the U.S. Government, including, among other matters, (1) information about the ownership interests of all corporations subject to Virgin Islands tax having non-Virgin Islands-source income and which receive a rebate, subsidy, or deduction of Virgin Islands taxes, as well as (2) information about any individual subject to Virgin Islands tax who has non-Virgin Islands-source income and who claims for the first time to be a Virgin Islands resident. In addition, TIA article 4(2)(b) provides that the Virgin Islands shall supply to the United States “copies of reports of individual, partnership, corporate, and employment audit changes that disclose information relevant to the United States.” Id. art. 4(2)(b), 1989-1 C.B. at 348-349. To this end, the TIA provides that the VIBIR will permit the IRS to examine Virgin Islands tax returns. Id. app. A, sec. 3.1, 1989-1 C.B. at 352.

III. The Validity of the Notice of Deficiency Under Scar v. Commissioner

In Scar, the notice of deficiency sent to the taxpayers was factually incorrect. The notice indicated that the Commissioner was disallowing a deduction for losses in a partnership called the Nevada Mining Project, in which the taxpayers had no interest or involvement whatsoever. See Scar v. Commissioner, 814F.2d at 1365. The notice also stated that the Commissioner had not actually examined the taxpayers’ income tax return. See id. Finally, in calculating the taxpayers’ tax liability, the Commissioner applied the top marginal rate of the time (i.e., 70%), instead of using the progressive tax rates prescribed in the Code. Id.

The Court of Appeals for the Ninth Circuit held that the notice of deficiency sent to the Scars was invalid. The court indicated that the determination requirement of section 6212(a) has substantive content. Id. at 1369. The Court of Appeals stated “that the Commissioner must consider information that relates to a particular taxpayer before it can be said that the Commissioner has ‘determined’ a ‘deficiency’ in respect to that taxpayer. To hold otherwise would entail ignoring or judicially rewriting the plain language of the Internal Revenue Code.” Id. at 1368-1369. The Court of Appeals in Scar found no “determination” had been made by the Commissioner because “the Commissioner’s purported notice of deficiency revealed on its face that no determination of tax deficiency had been made”. Id. at 1370.

In Clapp v. Commissioner, 875 F.2d 1396 (9th Cir. 1989), the Court of Appeals clarified its holding in Scar, stating: “Scar * * * [does not] require any affirmative showing by the Commissioner that a determination set forth in an alleged notice of deficiency was made on the basis of the taxpayers’ returns. Only

where the notice of deficiency reveals on its face that the Commissioner failed to make a determination is the Commissioner required to prove that he did in fact make a determination.” Id. at 1402. In Kong v. Commissioner, T.C. Memo. 1990-480, we stated: “Thus, the Court of Appeals for the Ninth Circuit has stated the general rule that where the notice of deficiency reveals on its face that the Commissioner failed to make a determination, respondent is entitled to prove that he did in fact make a determination.” See also Campbell v. Commissioner, 90 T.C. 110, 113 (1988) (“Where the notice of deficiency does not reveal on its face that the Commissioner failed to make a determination, a presumption arises that there was a deficiency *determination*.” (emphasis in original)).

In the motion to dismiss, petitioner’s counsel posits that the principles set forth in Scar are applicable in this case in that the explanation included in the notice of deficiency does not reflect the facts of the cases. The Explanation of Items states that petitioner participated in a tax avoidance scheme similar to that described in Notice 2004-45 and that the purpose of the transactions was to claim the 90% tax credit available under the EDP. Petitioner’s counsel asserts that petitioner never applied for or received tax credits under the EDP and therefore did not participate in “a tax avoidance scheme similar to that described in Notice 2004-45”.

Petitioner’s counsel’s arguments in the motion to dismiss are arguments as to the correctness of respondent’s determinations in the notice of deficiency, not the validity of the notice of deficiency. Our jurisdiction in this matter does not hinge on the correctness (or incorrectness) of respondent’s determinations in the notice of deficiency. As the Court of Appeals for the Ninth Circuit stated in Scar:

It is, of course true, as the dissent points out, that Tax Court jurisdiction does not depend on the existence of an actual deficiency.
* * * It is the purpose of the Tax Court to determine whether the Commissioner’s determination is correct. * * * “[I]t is not the existence of a deficiency but the Commissioner’s determination of a deficiency that provides a predicate for Tax Court jurisdiction.”

Scar v. Commissioner, 814 F.2d at 1370 n. 10 (citations omitted) . Unlike Scar, in these cases respondent clearly considered information specific to petitioner and made a determination with respect to him. The notice of deficiency informed petitioner that respondent made determinations based on the fact that petitioner did not file Federal income tax returns with the IRS. In making these determinations, respondent determined that petitioner was not a bona fide residents of the Virgin Islands. Because petitioner did not meet the first of section 932(c)(4)’s

requirements (i.e., the bona fide residency requirement), respondent determined that he had Federal filing and tax payment requirements that had not been fulfilled. We further note that the notice merely states that petitioner participated in a scheme similar to that described in Notice 2004-45.

We further note that petitioner does not claim that the computations respondent relied upon in making his determination do not relate to him. Indeed, the computations attached to the notice of deficiency makes it clear that respondent knew and considered each item reported on petitioner's tax returns filed with the VIBIR. The information on the notice of deficiency taken from petitioner's returns filed with the VIBIR are therefore not "allegations for which there had never been any substantial foundation" as had been determined in Scar. See Scar v. Commissioner, 814 F.2d at 1369. In any case, inasmuch as respondent determined that petitioner did not file returns, petitioner's counsel's argument is flawed because section 6211(a) makes clear that only "if a return was made by the taxpayer" does the tax "on a return" figure into the Commissioner's determination of a deficiency. If no return is made, which respondent determined was the case in this matter, the tax "reported" by the taxpayer on his return is considered as zero. Malone v. Commissioner, T.C. Memo. 1998-372; sec. 301.6211-1(a), Proced. & Admin. Regs.

The issues raised in the notice of deficiency as well as the computations made by respondent relate specifically to petitioner. Consequently we cannot say that the notice of determination reveals, on its face, that respondent failed to make a determination.

IV. Application of the Federal Rules of Civil Procedure to the Notice of Deficiency

Petitioner's counsel asserts that the notice of deficiency is equivalent to a civil complaint/pleading and that the notice fails the pleading requirements of Rule 8 of the Federal Rules of Civil Procedure (involving a plaintiff's claim for relief). This is not the first time this argument has been raised before this Court. See Cross v. Commissioner, T.C. Memo. 2012-344. Like the attorney in Cross, petitioner's counsel here cites no authority which characterizes a notice of deficiency as a civil complaint/pleading governed by the Federal Rules of Civil Procedure.⁴ Moreover,

⁴In Bokum v. Commissioner, T.C. Memo. 1990-21, aff'd, 992 F.2d 1136 (11th Cir. 1993), we noted that because a notice of deficiency does not result in final liability on the part of taxpayers, the issuance of a notice of deficiency is in many ways analogous to the filing of a civil

we have not been able to locate any such authority. Nor does counsel cite any authority applying the Federal Rules of Civil Procedure to a notice of deficiency.

The validity of the notice of deficiency is governed by a statute enacted by Congress, i.e., section 6212, not by the pleading rules of the Federal Rules of Civil Procedure. And our jurisdiction, governed by a statute enacted by Congress, i.e., section 6213(a), arises from the issuance of a valid notice of deficiency. Indeed, it has been said that notices of deficiency are the “tickets to the Tax Court”. See Laing v. United States, 423 U.S. 161, 206 (1976).

V. Conclusion

The notice of deficiency demonstrates on its face that (1) respondent determined deficiencies with respect to petitioner’s 2002, 2003, and 2004 Federal income tax, and (2) sets forth the amounts of the deficiencies the IRS determined. We thus hold that we have jurisdiction to redetermine petitioner’s tax liabilities. Consequently, we shall deny petitioner’s motion.

The premises considered, it is

ORDERED that petitioner’s motion to dismiss for lack of jurisdiction, filed November 12, 2014, is denied.

**(Signed) Julian I. Jacobs
Judge**

Dated: Washington, D.C.
April 14, 2017

complaint. However, our analogy was that the notice of deficiency is the document which initiates a case in the Tax Court, not that the pleading rules of the Federal Rules of Civil Procedure apply to the notice of deficiency.